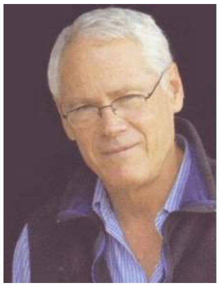

op/ed
by rob whiteley

IN SEARCH OF A BETTER BUSINESS MODEL

My Op/ed of September 27th (click here) detailed the fact that breeders lost more than $100 million in this year's Keeneland September sale. It's even scarier that breeders collectively *lost a half billion dollars* over the last four years.

No matter how spinners spin the spin, when an already struggling industry loses a half billion dollars in "churn" needed to re-supply the overall system, the only word that comes to mind is *crisis*.

On the surface, this is a crisis for breeders who form the headwaters or main tributary for the revenue stream from which many service providers drink. Below the surface, therefore, those who depend on the auction sales revenue stream will feel the pain. This should be obvious, because as the river shrinks, the fiscal health of every other group will be affected downstream. So when a half billion dollars of churn disappears (along with a lot of breeders and mares) *everyone* should pay attention and start talking about how to make things better.

My main purpose in writing this essay, therefore, is to help stimulate a dialogue that can produce an improved business model for breeding. Plain and simple, basic principles of Economics 101 indicate that making things better for breeders also makes things better for stallion owners, boarding farms, sale companies, consignors and agents, vets, feed and supply providers, transporters, farriers, industry magazines, and insurers, etc.

It's time to make some changes. The historic level of losses for breeders who form the foundation of the revenue pyramid means that sustainability of the business as we have known it is in jeopardy.

If you're not convinced that this is true, or still believe that we had a "good" sale in September with a gross of $219 million, please reflect on the following. In 1999, the gross for September was $233 million. That total achieved 13 years ago, however, is really $322 million in today's dollars (when adjusted for inflation using the CPI). This means that Keeneland's September sale gross in 2013 will have to increase 40% from this year's figure to $326 million in order to be equivalent to where we were in 1999.

What makes today strikingly different from 13 years ago, however, is the magnitude of cumulative losses that breeders have suffered and are carrying forward. Thus, we now rock unsteadily on the edge of a serious tipping point where breeder resiliency may give way to debilitating weakness.

So what to do? In going forward, we basically have only two choices. (1) We can keep on doing the same things we always do. But then, as Stephen Covey, author of *The Seven Habits of Highly Effective People* writes, "If we keep doing what we're doing, we're going to keep getting what we're getting."

Or (2) we can all acknowledge the crisis and respond to the challenges of a changing financial landscape by identifying proactive strategies and then creating new policies and practices accordingly. I favor this option because I believe that Charles Darwin had it right when he wrote, "It is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change."

Identifying things that could make a difference. So where can we look for changes that might make a difference in growing our breeding and sales business? Unfortunately, there aren't many places to look.

The most talked about topic is stud fees. If the 10 or 12 individuals who control the small number of "commercial" stallions would drop fees significantly to help breeders stay afloat, it would help a lot; even though stud fees are less than half of production costs (a $20K fee requires a $70K yearling sale to break-even). Semen sellers are not likely to drop their prices much, however, because many of them overpaid for their stallion corps and are now stuck trying to protect or recoup their investment. Furthermore, they often have fiduciary responsibilities to share holders that create upward pressure on fees.

Various market factors also operate to keep fees high. Fewer and fewer stallions with commercial luster or bling are available, creating a severe "supply and demand" imbalance. Because breeders must have access to the dwindling number of popular stallions if they want some chance of staying in business, it becomes easy and convenient for most stallion owners to see and treat breeders more as momentary cash cows than as valued, long-term customers.

In addition, stallion owners who control stallions perceived to be "commercial" also form a type of monopoly known as oligopoly. They do not operate in a truly "free" market where widespread competition naturally creates downward pressure on fees. (An oligopoly is a market condition that exists when there are fewer sellers. Oligopolies give sellers a great opportunity to inflate the prices of their goods, especially when demand exceeds supply and buyers have to have the product.) Thus, irrespective of long-term consequences, most stallion owners are inclined to set fees as high as they can because they can. It may not be smart business over time to do so (look what it's done for us, *or to us* to this point), but it gives a better short-term result on the bottom line.

Thus, we aren't likely to find much help in the form of a significant reduction in stud fees anytime soon. So where else can we look? The way contracts are written and terms and incentives are devised is a promising area to explore. ***Cont. p18***

It's time to change the contracts. Once upon a time, stallion contracts were universally "live foal – stand and nurse, payable September 1st of year bred." This has morphed into various payment forms, such as "up front, no guarantee," "live foal – stand and nurse, payable within 15 or 30 days of foaling," "out of proceeds," and "out of proceeds with forgiveness." Stallion owners have created flex in payment terms in order to justify high prices and to compete with one another.

The problem with all of these formats, however, is that the breeder takes virtually all of the risk. Even the "out of proceeds with forgiveness" concept becomes nothing more than cheese in the mousetrap, because it allows the setting of inflated fees, and when the yearling does not bring the contracted fee, the stallion owner takes all the proceeds and the breeder eats the $40-100K in other production costs.

In addition, the breeders' risk is magnified because breeders and stallion owners do not share the same time-table. Stallion owners operate annually from February 15th to June 15th. Breeders, however, are on a two and a half year calendar from the time they breed their mare to the time they take their yearling to auction. In a world where a lot can happen in a day, having to spin the wheel for two and a half years can be very punitive, especially in a down market.

Furthermore, with the advent of large (sometimes huge) books, mare owners don't know what they're really getting when they sign on the dotted line. Except in rare instances, they don't know how many mares will be bred to the stallion. In the unwelcome instance where stallions are booked to more than 100 mares, the result is usually a depressing situation for breeders at the sales because they face intensified competition from a very large number of yearlings by the same sire. That is, if they get a live foal and get to the sale. When books are allowed to soar past 100 (and incredibly past 200), breeders are additionally slammed by not being able to get to a stallion when the mare is ready, missing a cover, having to accept lesser semen quality from too many covers on the same day or season, and having more late foals or no foals caused by a backed up breeding shed. These greedy practices add great hidden cost to the price of a stud fee.

Thus, contracts should be required to *specify the maximum number of mares that will be serviced* when the contract is signed. In addition, contracts should included some form of spelled out compensation or credit against fees when and if Kentucky stallion owners sell a stallion out of the country or to a regional market, which leaves the breeder holding the bag with the meter running and a foal in the belly, a foal on the ground, a yearling to sell, or all three.

Universally changing contract terms in these ways to produce a proactive model that shares the risk will greatly help the breeder to stay in place and keep coming back. In the short run, stallion farms may experience reduced revenue from making these changes, but in the long run the new policies will help to grow and perhaps save the business as we know it, for everyone.

Sharing the risk. The concept of shared risk is espoused by B. Wayne Hughes of Spendthrift Farm who knows a thing or two about growing a business, having built a $17 billion dollar company from scratch. He knows better than any of us that "when the customer comes first, the customer will last." His "Breed Secure Program" takes payment out of proceeds, but only after the yearling seller gets the first $12,000.

John Phillips of Darby Dan Farm created a similar concept in 2009 called the "Profit Protection Program." This, too, is a pay from proceeds contract where the first $5,000 goes to the breeder and any remaining proceeds are split 50/50 until the advertised stud fee has been paid.

Some meaningful variation of these two concepts needs to be universally adopted by stallion farms at this time of industry crisis.

Sharing the rewards and seeing breeders as partners in making a stallion. B. Wayne Hughes is also a pioneer in this regard. Not only was he outspoken about breeders taking almost "all the risk," but he established an innovative breeding-right program for breeders at Spendthrift called "Share The Upside." In this concept, mare owners can earn a limited number of non-equity, life-time breeding rights with no maintenance expense in return for buying a fixed number of initial seasons at market price to help the stallion owner get a new stallion off the ground.

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This concept gives the breeder some protection if the stallion is a dud in the sales arena, provides a deserved return on stud fee investment if the stallion hits, secures access to the stallion in future years, and develops customer loyalty for the stallion owner.

Not surprisingly, Rick Porter (another highly successful businessman who knows that appreciating customers makes things better for everyone) utilized the same concept with his promising young stallion, Old Fashioned. This concept should be standard practice whenever any new stallion prospect goes into service.

A last point related to "sharing the rewards" is that breeders should be appreciated with a comp season when they breed a Grade 1 or major stakes winner. That breeder has helped to raise the image of the stallion which often leads to a raised stud fee, and should be rewarded accordingly.

Final comment. As I stated at the top of this Op/ed, my main purpose is to help stimulate a dialogue that can produce an improved business model for breeding. Basic principles of Economics 101 indicate that making things better for breeders also makes things better for every industry group in the long run. As mentioned above, some stallion farms have been innovative and proactive, but there is still tremendous room for creativity with the purpose of generating more total sales revenue and improving the breeding business for all participants.

Your thoughts on making things better for everyone are welcome.

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